Department of Revenue

For the Year Ended
June 30, 1998

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October 5, 1999

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Ruth Johnson, Commissioner
Department of Revenue
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Revenue for the year ended June 30, 1998.

We conducted our audit in accordance with generally accepted government auditing standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we obtain an understanding of management controls relevant to the audit and that we design the audit to provide reasonable assurance of the Department of Revenue's compliance with the provisions of policies, procedures, laws, and regulations significant to the audit. Management of the Department of Revenue is responsible for establishing and maintaining internal control and for complying with applicable laws and regulations.

Our audit disclosed certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report. The department's administration has responded to the audit findings; we have included the responses following each finding. We will follow up the audit to examine the application of the procedures instituted because of the audit findings.

We have reported other less significant matters involving the department's internal controls and/or instances of noncompliance to the Department of Revenue's management in a separate letter.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/rm
99/058

State of Tennessee

Audit Highlights

Comptroller of the Treasury — Division of State Audit

Financial and Compliance Audit
Department of Revenue
For the Year Ended June 30, 1998

AUDIT SCOPE

We have audited the Department of Revenue for the period July 1, 1997, through June 30, 1998. Our audit scope included a review of management's controls and compliance with policies, procedures, laws, and regulations in the areas of Management Information Systems, Processing, Taxpayer Services, Taxpayer Accounting, Revenue Accounting, Tax Enforcement, Internal Audit, and compliance with the Financial Integrity Act. The audit was conducted in accordance with generally accepted government auditing standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

OBSERVATIONS AND COMMENTS

Revenue Integrated Tax System (RITS)
This is the second audit conducted since the Department of Revenue began implementing the Revenue Integrated Tax System (RITS). While the department has made progress with the system, there are still problems. Due to the major impact RITS has on the department's operations, it is appropriate to provide an overview of the progression of the system to this point.

In 1991, the department began planning for a fully integrated tax system to encompass 32 taxes. When completed, the system will process over two million transactions per year and account for and distribute over $7 billion per year. The first tax was implemented in April 1995 and the last tax was implemented in March 1999. Also, the Office for Information Resources took over maintenance of RITS from the third-party contractor on March 1, 1999.

AUDIT FINDINGS

The Department's Revenue Integrated Tax System Has Numerous System Problems*
As noted above, the Department of Revenue has been implementing the RITS system for the last four years. The system has had numerous problems during its implementation, some of which have been very significant (page 3).

Balancing Problems Are Still Occurring in RITS*
Numerous balancing problems are still occurring in RITS accounting reports. The number of out-of-balances have gone up from the prior year and the underlying causes of the out-of-balances have not been corrected (page 4).

Problems With RITS Delayed Disbursements to Other States for International Registration Plan Taxes
Fees collected by the state that were owed to other states had not been disbursed to those respective states in a timely manner. As of June 30, 1998, the unpaid amount due to other states totaled over $42.1 million and was not paid for as long as six months after the fees were collected (page 6).

The Department's Disaster Recovery Plan Needs Improvement*
As noted in the prior audit, the department's disaster recovery plan is not current and does not address the continuity of the major operational function of the department (page 7).

Management Information Systems (MIS) Policies and Procedures Manuals Need to Be Updated*
As noted in the prior audit, the department's MIS policies and procedures are still not up-to-date (page 8).

RITS Security Needs to be Improved*
As noted in the prior audit report, the department's controls over employees' access to RITS need improvement (page 9).

Improved Controls Over Program Changes in MIS Are Needed*
As stated in the prior audit, computer programs called SPUFIs (Sequential Processing User File Input) are being used by Management Information Systems (MIS) staff to correct taxpayer accounts directly in the system rather than through properly authorized and documented transactions (page 11).

Procedures Regarding Changes to Taxpayer Account Balances Are Not Being Followed
As of June 4, 1999, one Employee Transaction Activity report had been generated and reviewed. This is not in compliance with the department's Guidelines for Account Balance Changes on RITS (page 14).

Refunds Are Not Always Processed Correctly by RITS or Properly Reflected in Taxpayer Accounts*

As noted in the prior year's audit, there were significant problems with the way RITS processes refunds and posts them to the taxpayer accounts, which could result in duplicate refunds being made to the taxpayers (page 15).

The Department Does Not Properly Track and Monitor Refund Claims in Order to Minimize Interest Paid

The Refund and Penalty-Waiver Unit is not closely monitoring refunds to ensure that they are sent through the signature process to ensure payment is made within 45 days from the date of the claim as required by state law. Because of this, the state paid out $371,610.20 in interest on late refunds (page 17).

Controls in the Tax Enforcement Division Need Improvement*

The department is not maintaining adequate control over bankruptcy claims, timely follow-up on delinquent cases, and the officer diaries in the regional offices (page 20).

* This is a repeat audit finding.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
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(615) 741-3697

Audit Report
Department of Revenue
For the Year Ended June 30, 1998

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For the Year Ended June 30, 1998

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Revenue. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

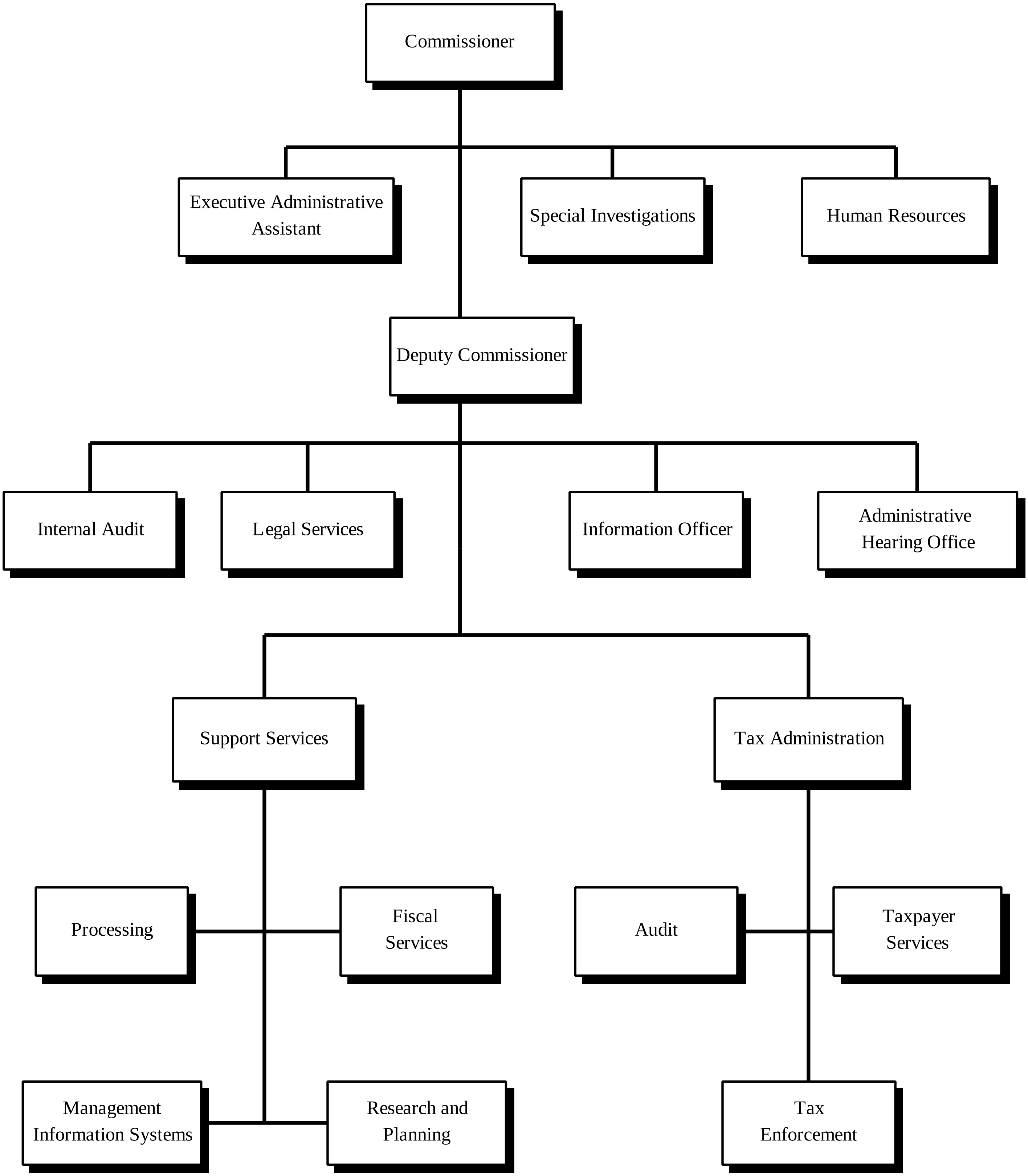
The mission of the Department of Revenue is to collect state revenue. Specifically, the department is responsible for the collection of most state taxes and fees, enforces the revenue statutes of the state to ensure that taxpayers are in compliance with all tax laws, and prepares the monthly apportionment of revenue collections for distribution to various state funds and local units of government. The department also offers taxpayer assistance and taxpayer education. In an effort to perform its duties, the department has divided these functions into six divisions: Administration, Tax Enforcement, Management Information Systems, Taxpayer Services, Field Audit, and Processing.

An organization chart of the department is on the following page.

AUDIT SCOPE

We have audited the Department of Revenue for the period July 1, 1997, through June 30, 1998. Our audit scope included a review of management's controls and compliance with policies, procedures, laws, and regulations in the areas of Management Information Systems, Processing, Taxpayer Services, Taxpayer Accounting, Revenue Accounting, Tax Enforcement, Internal Audit, and compliance with the Financial Integrity Act. The audit was conducted in

TENNESSEE DEPARTMENT OF REVENUE



accordance with generally accepted government auditing standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

REVENUE INTEGRATED TAX SYSTEM (RITS)

This is the second audit conducted since the Department of Revenue began implementing the Revenue Integrated Tax System (RITS). While the department has made progress with the system, there are still problems. Due to the major impact RITS has on the department's operations, it is appropriate to provide an overview of the progression of the system to this point.

In 1991, the department began planning for a fully integrated tax system to encompass 32 taxes. When completed, the system will process over two million transactions per year and account for and distribute over $7 billion per year. The first tax was implemented in April 1995 and the last tax was implemented in March 1999. Also, the Office of Information Resources took over maintenance of RITS from the third-party contractor March 1, 1999. The RITS system still has system problems that need to be corrected as soon as possible.

In addition to the findings, other minor weaknesses came to our attention which have been reported to management in a separate letter.

1. <u>The department's RITS has numerous system problems</u>

Finding

As noted in the prior audit, the Department of Revenue began the implementation of the Revenue Integrated Tax System (RITS) in April 1995. Taxes have continuously been added throughout the last four years.

The system has had numerous problems, some of which have been very significant. Although management has made improvements in the area of segregation of duties over revenue accounting transactions and properly processing taxpayer payments and accounts, the following system problems which were noted in the prior audit have not been corrected:

- System-generated accounting reports have been out-of-balance on a continuous basis (finding 2).
- The department's disaster recovery plan needs improvement (finding 4).
- Management Information Systems policies and procedures manuals need to be updated to include RITS (finding 5).

- The security over RITS needs to be improved (finding 6).
- The department needs to improve controls over RITS program changes (finding 7).
- Procedures regarding changes to taxpayer account balances are not being followed (finding 8).
- Refunds are not always processed correctly by RITS or properly reflected in taxpayer accounts (finding 9).

In addition to the above repeated problems, we also found that problems with RITS delayed disbursements to other states for International Registration Plan Tax (finding 3).

These system problems have created numerous processing and accounting errors involving tax returns and collections. The department is now working with the Office for Information Resources, which has taken over ongoing support and enhancement of the system.

Recommendation

The commissioner should ensure that all the system problems in RITS are corrected as quickly as possible.

Management's Comment

We concur. The Revenue Integrated Tax System (RITS) has experienced system problems that are addressed separately in the responses to findings 2, 3, 4, 5, 6, 7, and 9. RITS has experienced problems that are characteristic to the implementation of a large system and/or attributable to the integration of such a large number of taxes. These system problems are being monitored and resolved as quickly as possible.

2. Balancing problems are still occurring in RITS

Finding

As noted in the prior audit, numerous balancing problems are occurring in RITS accounting reports. From July 1, 1997, until June 30, 1998, RITS was out-of-balance 234 of 248 days, or 94% of the time. The debits and credits of the Internal Tax Change columns do not equal, which creates an out-of-balance condition. One type of out-of-balance condition can occur when the taxes are moved around in the system internally because of line item adjustments, transfers, refunds, bad checks, conversion to RITS, and system problems. The out-of-balances were tested to determine if the problems were properly corrected and supported; however, 11 of 60 Internal Tax Change out-of-balances (18%) did not have adequate support. Management concurred with the prior finding and stated that the out-of-balances are being corrected before the monthly close out. Management stated that they were working with consultants to develop a program that should correct the majority of out-of-balances. However, the number of out-of-balances has increased. The underlying causes of the out-of-balances have not been corrected.

A SPUFI (Sequential Processing User File Input) program was created by Management Information Systems to correct these out-of-balances. However, the controls that the system is designed to provide are being circumvented. (This lack of controls over program changes is discussed in finding 8.)

Reconciliations between the year-to-date net collections on the daily summary of collections report and the collections on the undistributed report remained out-of-balance 10 out of 50 days, or 20% of the time, because of a system problem. Undistributed revenue is out of balance with the daily summary of collections report, which reflects daily deposits, and the daily balancing report. These problems had already been detected by management and have been resolved, but the system problems causing the out-of-balance situations still have not been corrected. Management is aware of the balancing problems occurring since the implementation of RITS in 1995. Revenue employees have been routinely working to correct the individual problems through on-line maintenance.

Recommendation

The Commissioner should continue to monitor and document the problems associated with RITS out-of-balances and ensure that proper measures are implemented as quickly as possible to prevent the out-of-balance problem.

Management's Comment

We concur. Since March 1999, the Department of Revenue's Management Information Systems (MIS) personnel and Office of Information Resources' (OIR) staff have been meeting on a daily basis to discuss items on the out-of-balance report, outstanding balancing problems, and the status of requested program revisions. Program changes have been made in both Taxpayer Accounting and Revenue Accounting to help resolve some of the major balancing issues. Additional work is currently being done on processing of refunds and line item adjustments.

An additional out-of-balance report has also been implemented in an attempt to eliminate some of the "false" out-of-balance conditions by balancing at the taxpayer account level instead of at the transaction group level. This process does not affect the "net" out-of-balance for the day but it does help in giving a more realistic picture of the number of actual out-of-balance conditions.

The method for correcting out-of-balance conditions has been revised. Effective September 7, 1999, MIS no longer creates SPUFI (Sequential Processing User File Input) statements to correct out-of-balance conditions except in specified situations where there are no

RITS conversations for correcting the data in question. In these rare situations, the SPUFIs will be well documented with the necessary authorizations.

Instead of using SPUFI statements, Fiscal Services personnel are now entering all RTRANS transactions (a transaction to update the general ledger) using RITS conversation R515, which was designed for this purpose. MIS continues to provide Fiscal Services with a daily report of RTRANS transactions required to resolve any out-of-balance conditions.

Personnel in MIS will continue to closely monitor the RITS balancing problems and work to solve these issues with the assistance of OIR.

3. <u>Problems with the RITS delayed disbursements to other states for International Registration Plan Taxes</u>

Finding

A review of International Registration Plan Tax balances revealed that fees collected by the state that were owed to other states had not been disbursed timely between March 1998 and July 1998. As of June 30, 1998, the unpaid amount due to other states totaled over $42.1 million, and was not paid for as long as six months after the fees were collected. The fees should normally be remitted to other states within one month of collection. Problems with the Revenue Integrated Tax System (RITS) slowed the payment of fees to other states.

Recommendation

The department should ensure that the other states receive their Motor Vehicle International Registration Plan taxes timely. Management should ensure that the RITS system problems are corrected.

Management's Comment

We concur. The problem with RITS and IRP fee disbursements was corrected and all state disbursements were brought up-to-date in December 1998. The department currently disburses fees each month within the timeframe required by the Plan. This situation should not occur in the future.

MANAGEMENT INFORMATION SYSTEMS

The objectives of our review of the Management Information Systems (MIS) division were to determine whether

- clear assignment of responsibilities and segregation of functions are provided;
- relevant policies and procedures have been placed in operation;
- computer resources are planned, managed, and utilized effectively;
- an adequate disaster recovery plan has been implemented;
- user access to RITS is adequately controlled;
- RITS application documentation is complete; and
- adequate controls are in place over RITS program changes.

We examined the policies and procedures manuals to determine if policies and procedures were current and reflected existing operational conditions, and if the disaster recovery plan was current. We interviewed key personnel, observed operations, and reviewed support documentation to determine if application controls were appropriate and in place. We looked for proper security of access to RITS screens, correct computer logic for math audits of Franchise and Excise tax returns, and the use of SPUFIs to correct taxpayer account out-of-balances. We examined RITS documentation to determine if the system was adequately documented. Discrepancies were noted regarding inadequate disaster contingency planning (finding 4), inadequate MIS policies and procedures manuals (finding 5), weak security over access to RITS (finding 6), and a lack of controls over program changes (finding 7). In addition to the findings listed below, other minor weaknesses came to our attention, which have been reported to management in a separate letter.

4. The department's disaster recovery plan needs improvement

Finding

As noted in the prior audit, the Department of Revenue's disaster recovery plan is not current and does not address the continuity of the major operational function of the department. Management concurred with the prior finding and stated their goal was "to have a business resumption plan developed by the end of 1998." They did not meet their goal. The department's disaster recovery plan contains outdated backup and recovery procedures. The plan contains no backup and recovery procedures for the Revenue Integrated Tax System (RITS), nor does it reflect the current divisions of the department. The phone lists in the plan are not current and contain home numbers of employees who have left the department.

Also, the department does not have a contingency plan to provide continuity of administrative, clerical, and operational functions if its office and related work areas are damaged or destroyed.

The potential for interrupted service and lost data increases significantly without an adequate recovery plan. The department does not have a plan to ensure the continuity of processing tax collections and depositing those funds in the event of an emergency or disaster.

Effective management planning requires that procedures be adopted to restore departmental operations in the event of an emergency or disaster.

Recommendation

The department should develop and test a disaster recovery plan that includes, but is not limited to, data backup and recovery; system recovery; relocation to a temporary site; provision for telephones and communications; and acquisition of office equipment, furniture, supplies, and forms necessary to carry out its tax-collecting operations.

Management's Comment

We concur. The department is committed to meeting the requirements for developing a Business Resumption Plan (BRP) in accordance with the state standards issued by the Center for Effective Government (CEG). The final version of the department's BRP was submitted to the CEG in August 1999 and is currently under review by that agency.

Once approved, the department intends to test the plan under the guidance of the Tennessee Emergency Management Agency (TEMA) by orchestrating a "mock disaster". This will be a learning experience for personnel within the department since a mock disaster has never been conducted in the department.

The department continues to participate in every Disaster Recovery drill conducted by the Department of Finance and Administration. The last drill conducted on April 15-16, 1999, resulted in the successful recovery of RITS.

5. Management Information Systems policies and procedures manuals need to be updated

Finding

As stated in the prior audit, Management Information Systems policies and procedures manuals were not up-to-date. Management concurred with this assessment and stated they were "in the process of updating this manual." However, no progress has been made in this area. The manuals did not contain the necessary policies and procedures for the Revenue Integrated Tax System (RITS), which was implemented in December 1995. They have implemented some procedures such as Request for SPUFIs; however, they are not adequate. Documented policies and procedures would help management plan, control, and evaluate its Management Information Systems. If management's policy directives are not developed and communicated, department staff may not understand and adhere to approved policies and procedures. Adequate policies and procedures for systems development and program changes could have prevented some of the problems with SPUFIs.

Recommendation

Management should update the management information systems policies and procedures manuals to include new directives for the RITS system and ensure they are distributed to the appropriate staff.

Management's Comment

We concur. The Management Information Systems Division is in the process of updating the Policies and Procedures Manuals. This project should be completed by the end of November 1999.

6. RITS security needs to be improved

Finding

Security over the Revenue Integrated Tax System (RITS) needs improvement in the following areas:

a. As noted in the prior audit, written authorization for access to RITS is not always maintained. Four of 41 security authorization forms tested (9.8%) were not properly approved. Written authorization for employees' access to RITS screens is necessary to document what access management intends for specific employees to have. Also, new problems were found as discussed below.

b. The RACF warning indicator on all RITS data sets was set at "Yes." This means the warning indicator was activated and would only issue a warning rather than fail a request to access the data set.

c. RACF data set groups have undefined users such as conversion review. All users should be defined to the system in order to maintain accountability.

d. There was a failure in security for "conversation R301," which is the IRP Registration screen. The screen was intended to provide users with either inquiry or update access. Security was not working properly; therefore, anyone with access to "conversation R301" could make changes to IRP.

e. As a result of a change in job duties, one user had special privileges of Special and Auditor when the user did not need the access to perform job duties.

f. Three MIS analysts had pass dates of 90 days. A pass date is the number of days a password works before a new one is required. Per MIS procedures, employees should not have pass dates exceeding 30 days.

Recommendation

MIS management should review the RITS security authorization forms on file and obtain authorization for any users not documented. Access to RITS should not be given until a properly completed and approved authorization form is provided to the security administrator. The RACF warning indicator should be set to "No." All user accounts not specifically tied to an individual should be deleted. Inquiry access to "conversation R301" should be suspended until security is fixed, tested, and determined to be working properly. Special privileges and pass dates should be reviewed on a regular basis.

Management's Comment

We concur. Adequate security of the system is of paramount importance to the department. RITS security is continually monitored by personnel in the Management Information Systems Division (MIS).

MIS personnel do not provide access to RITS until a properly completed and approved authorization form is provided to the Security Administrator. To ensure that all documentation is on file and up-to-date, during the current fiscal year, MIS is developing a plan to reauthorize security for all RITS users.

While access to RITS databases is secured by Data Base Administration (DBA) and cannot be accessed by the user unless the user is authorized by DBA, MIS has changed the RACF warning indicators to "no" as recommended.

The need to define groups of persons to a common RACF user ID to perform particular functions has been discussed with the State Security Administrator in the Office of Information Resources (OIR). Permission was obtained for the Control Room personnel in MIS. The department took this action because of the need to connect some processors to systems instead of individuals to more efficiently perform the job responsibilities.

The failure in conversation R301 was caused by a programming revision that bypassed security. Program revisions to correct this problem will be completed by October 15, 1999.

The individual who had special privileges was kept as a security backup after his change of job duties. In response to this audit finding, his special privileges and ability to serve as backup were removed. The pass dates of all systems security personnel have been set to 30.

7. Improved controls over program changes in MIS are needed

Finding

As stated in the prior audit, computer programs called SPUFIs (Sequential Processing User File Input) are being used by Management Information Systems (MIS) staff to correct taxpayer accounts directly in the system rather than through properly authorized and documented transactions. (Management is using SPUFIs to correct problems caused by RITS.) Making changes directly to the system with a SPUFI, instead of correcting errors through transactions, circumvents the controls the system is designed to provide, leaving no audit trail for management to determine the activity in an account. Therefore, SPUFIs need to be properly documented so that an audit trail exists and management can review changes made with SPUFIs. MIS employees are now using a SPUFI log and numbered forms for SPUFI requests. However, the forms are not consistent, and MIS has not followed its own procedures.

The documentation for 7 of 67 SPUFIs (10.4%) selected for testwork was missing. Forty-two of 60 SPUFIs tested (70%) were not approved before the change was made. Twenty-five of 60 SPUFIs tested (41.7%) were not signed by the Data Base Administrator but by a member of MIS. Six of 60 SPUFIs tested (10%) were not approved by the Assistant Director of MIS, as required by the department's Standard Practice Procedures for Data Fixes. Twenty-five of 60 SPUFIs tested (41.7%) had the same individual signing and performing the tasks of the production manager, granting approval for the change and for Office of Information Resources Data Base Administrators, indicating he made the change, and again initialing that it was reviewed by him. On 2 of the same 25, the same individual was also the analyst who originally made the request. Without proper procedures and adherence to those procedures, there is a lack of accountability and a possibility that errors could occur and go undetected.

Also, MIS analysts are running SPUFIs on production data. OIR programmers normally execute these types of programs. Originally the access was obtained for after-hours emergencies; however, now the analysts are running SPUFIs on a regular basis. Analysts are responsible for program design and should not have access to change production data. With the ability to design programs and access production data, taxpayer accounts could be compromised.

Recommendation

Proper controls should be placed over SPUFIs. SPUFIs should not be routinely used to correct out-of-balance conditions, but rather the problem in RITS should be identified and corrected in RITS to eliminate future problems. The use of SPUFIs should be kept to a minimum, and departmental procedures over the use of SPUFIs should be enforced by management. Duties should be adequately segregated to provide security over data and to establish accountability for all changes made to the data. Analysts should not make direct changes to data.

Management's Comment

We concur. As stated in the response to Finding 2, SPUFIs will no longer be used to correct out-of-balance conditions except in certain situations where RITS conversations cannot be used for correcting the data.

A standard format for all SPUFIs was developed as of June 1998. The procedures for approving and running SPUFIs for data correction are being reviewed to ensure that the best methods of control are utilized. A cover sheet accompanies each request setting forth the required information needed and providing for the appropriate approval signatures. Documentation on who is requesting the work and the need for the SPUFI must be detailed before the manager will approve the request. Once the work is performed and the testing is done, the information is reviewed to make sure that the SPUFI did what was requested and that the testing has been performed. At the time, the reviewer signs off. The signing procedures are being revised to ensure that each form is properly completed.

Since all taxes have been placed on RITS, the number of SPUFIs required to maintain the system has dropped. Now, only a few designated managers, one consultant and one lead analyst are authorized to run SPUFIs. These personnel were selected because of the nature of their job responsibilities; areas within the department supported, or time of day/night that would require immediate attention/support.

PROCESSING DIVISION

Our objectives in the area of the Processing Division were to determine whether

- policies and procedures that affect each unit of the Processing Division have been identified,
- the division is complying with the policies and procedures of the department,
- funds received by the Processing Division are properly safeguarded and deposited in a timely manner,
- remittances are being properly recorded by the Exceptions Processing Unit, and
- the Exceptions Processing Unit adequately safeguards funds and makes deposits in a timely manner.

An understanding of the procedures and controls of the division was obtained and documented. The process of safeguarding revenue received was observed and discussed with the appropriate personnel. A sample of cash receipts was tested to determine if deposits were made timely by the Processing Division and the Exceptions Processing Unit. We had no findings related to the Processing Division; however, some minor weaknesses came to our attention and have been reported to management in a separate letter.

TAXPAYER SERVICES

The objectives of our audit in the area of Taxpayer Services were to determine whether

- certain rules, regulations, and laws that affect taxpayer registration have been identified;
- taxpayer applications for registration for the audit period have been correctly coded and processed;
- the section's managerial controls over corrections and changes to taxpayer account balances in the Revenue Integrated Tax System are effective; and
- the procedures for adding and deleting taxpayer accounts are proper.

We interviewed key personnel to gain an understanding of the department's procedures and compliance with rules and laws. Certain rules, regulations, and laws that affect taxpayer registration were identified and reviewed. We obtained a sample of corporations doing business in Tennessee from Secretary of State records and traced these entities to the taxpayers listed on RITS to determine if the corporations were properly recorded or properly removed. Employees having access to make corrections and changes to taxpayers' accounts on RITS were reviewed for proper authorization. We had no findings related to the Taxpayer Services; however, some minor weaknesses came to our attention and have been reported to management in a separate letter.

TAXPAYER ACCOUNTING

The objectives of our work in the area of taxpayer accounting were to determine whether

- certain rules and laws that affect tax collections have been complied with;
- controls over the refund process for taxpayer accounting are adequate;
- reconciliations are performed and are properly reviewed;
- refunds have been reviewed, properly approved, and recorded to the correct taxpayer account;
- transactions and conversation screens are secure from unauthorized use; and
- STARS and RITS refunds reconcile.

We interviewed key personnel to gain an understanding of the department's procedures and compliance with rules and laws that affect tax collections. Security over access to RITS was reviewed. The refund process was reviewed, and a sample of refunds was tested for proper documentation and approval. Testwork was also performed to follow up on the prior audit finding concerning inadequate procedures for changing taxpayer accounts. In addition to the findings listed below, other minor weaknesses came to our attention and have been reported to management in a separate letter.

8. Procedures regarding changes to taxpayer account balances are not being followed

Finding

As noted in prior audits covering the past 14 years, procedures regarding changes to taxpayer account balances were inadequate. Management concurred and established Guidelines for Account Balance Changes on the Revenue Integrated Tax System (RITS) and implemented them September 19, 1997. Included were supervisory review guidelines written for the Employee Transaction Activity report. The report is generated from RITS and was in the production process from June 1997 until March 1999. This activity report reflects individual and group transaction activity that details the account accessed and the changes made by an individual or group. This report also includes the amounts that were changed and how this affected the taxpayer's account. However, the procedures for the review of this report are not being followed.

As of June 4, 1999, one quarterly Employee Transaction Activity report had been generated and reviewed for the period from July 1, 1997, to June 4, 1999. This is not in compliance with the department's Guidelines for Account Balance Changes on RITS that state "supervisors should review this report weekly." Management's review and approval of adjustments made to taxpayer account balances are essential to ensure that only legitimate and necessary changes are made, and these reviews must be timely to be effective.

Recommendation

The Director of the Audit Division should ensure that the supervisors are following the division's approved procedures for account balance changes on RITS.

Management's Comment

We concur. Audit Division management will ensure that supervisors and employees are following the department's approved procedures for account balance changes on RITS.

9. <u>Refunds are not always processed correctly by RITS or properly reflected in taxpayer accounts</u>

Finding

As noted in the prior year's audit, there were significant problems with the way Revenue Integrated Tax System (RITS) processes refunds and posts them to taxpayer accounts. The system does not always process refunds correctly. When refunds do not process correctly, the department has to prepare the refunds manually (not through normal RITS processes). When refunds are processed manually because of problems with RITS, the manual refunds also do not post correctly to the taxpayer's account. In addition, proper support for refunds is not always maintained.

Also during the period from April 1997 to March 1999, no refunds were automatically generated due to RITS system problems. Originally RITS was programmed to automatically generate franchise and excise refunds that are less than $5,000 and personal income refunds less than $1,000.

When refunds process correctly on RITS, the system interfaces with the State of Tennessee Accounting and Reporting System (STARS) to prepare the warrants. When refunds do not process correctly in RITS, they are processed manually on STARS and an interface with RITS occurs. During this interface, the taxpayer's account should be updated to clear the credit and document the refund payment information in the taxpayer's account on RITS. However, this interface does not always function properly, and taxpayer accounts are not updated to reflect these refunds, creating the potential for duplicate refunds. Even though management and the MIS division have made improvements, problems persist with processing refunds and posting refunds to the taxpayer account correctly. Six of 12 manual refunds tested (50%) were generated because of RITS problems.

In the prior year's audit, it was noted that manual refunds were not properly reflected in the taxpayer's account due to RITS problems. The department concurred and stated that many of the refund problems have been corrected and management is closely monitoring the refunds that have been issued manually. It appears from reviewing the Daily Reconciliation Report generated by Fiscal Services that manual refunds are being monitored; however, it was noted that some manual refunds may appear on the reconciliation report as unresolved for several months. Based on conversations with the Fiscal Services staff, a follow-up on these problems is not begun until there is a persistent problem that has been on the report for several months and has not been corrected. Fiscal Services then takes the initiative to contact someone to fix the problem. Refunds that are not properly reflected in the taxpayer's account at the time of the refund could result in duplicate payments being made to the taxpayer.

For 6 of 12 manual refunds tested (50%), there was no identifying information as to account number, entity ID, or the refund period listed on the STARS Voucher Register or the Manual Refund Register. Management concurred with last year's finding and stated that Fiscal Services will be provided with the taxpayer ID, account number, type of tax, refund period, and other vital information needed to process the refund check. In addition, there was not any additional information in the Check Register, where a printout of all identifying information is added when manual checks are generated. Not having proper documentation or identifying information for a refund claim could lead to the incorrect payment of refunds.

Recommendation

RITS problems should be corrected in a timely manner so that refunds process correctly and are accurately posted to taxpayer accounts.

The Refund and Penalty-Waiver Unit should provide all identifying information to Fiscal Services to support the manual refund amount. Fiscal Services should include this information both in the Check Register and on the STARS Voucher Register to easily trace the refund to supporting documentation.

Either the Refund and Penalty-Waiver Unit or Fiscal Services should follow up on RITS refund problems on a regular basis to ensure that these problems are corrected in a timely manner.

The Refund and Penalty-Waiver Unit and Fiscal Services should work closely with MIS to ensure that RITS is processing refunds and posting refunds properly so that refunds will be accurately reflected in the taxpayer's account.

Management's Comment

We concur. The RITS refund process continues to improve. When problem reports are received, MIS gives each a priority status and they are then handled in order of critical importance. The program changes are timely tested and data fixes are then run to update taxpayer accounts. These program changes have corrected isolated system problems.

Significant improvements have been made over the past fiscal year to improve Revenue Accounting controls in tracking all refunds paid through STARS and RITS. Spreadsheets have been created to track all refunds processed and the information is compiled at month-end. All refunds, including manual refunds, are tracked daily. To the best of the knowledge of personnel within Fiscal Services, all refunds processed through Taxpayer Accounting have been properly accounted for in Revenue Accounting and in STARS.

The Supervisor of the RPW Unit and a representative of the Fiscal Services Division developed a specific format to be used in requesting manual refunds by identifying information for better documentation and support for each refund. Procedures were established for retention of this support information. Under this procedure, manual refunds are not issued without the proper requests.

To resolve the issue of the voucher registers not having proper entity ID's or account numbers, all manual refunds are now created via the vendor files in STARS. This process was implemented after the first of the 1999 calendar year to enhance the proper accountability of manual refunds processed.

The Audit Division will continue to work with Fiscal and MIS to get any problems corrected and the refunds processed correctly on RITS.

10. The department does not properly track and monitor refund claims in order to minimize interest paid

Finding

The department does not properly monitor individual refund claims to prevent excess interest from being paid. Sixteen of 17 Franchise and Excise refund claims over $50,000 took from 48 to 699 days to process in the Refund and Penalty-Waiver Unit prior to being sent to the Attorney General's office for signatures. All claims over $50,000 must be sent to the Attorney General's office for approval. There were also problems noted with refunds remaining in the Attorney General's Office. Nine of 17 refund claims were held in the Attorney General's office, ranging from 32 to 284 days.

It appears that the Refund and Penalty-Waiver Unit is not closely monitoring refunds to ensure that they are sent through the signature process to ensure payment is made within 45 days from the claim date. The claim date is the date that the Refund and Penalty-Waiver Unit establishes a refund claim as a valid refund. Procedures have not been established by the department to ensure that a refund is sent through the signature process and refunded within 45 days as required by state law. Section 67-1-801(b), *Tennessee Code Annotated*, states:

> When it is determined by administrative review or court order that any person is entitled to a refund or credit of any tax collected or administered by the commissioner, interest shall be added to the amount of refund or credit due, beginning forty-five (45) days from the date of filing a claim for refund.

When refunds are not processed within 45 days of the claim date, the state is assessed interest on the refund amount. The amount of interest the state could have saved if these 16 refunds were processed timely amounted to $371,610.20.

Recommendation

The department should establish procedures for tracking and monitoring refund claims. These procedures should be adequate to ensure that the refund will be approved and will have all required signatures within 45 days to comply with the statute. This would allow the department to appropriately track the refund during the process to ensure the refund does not remain in one area for an excessive amount of time. The department should also assess the reasons for delay and establish a plan to prevent these problems from recurring.

The department should work closely with legal staff and the Attorney General's office to establish an appropriate timeline for the signature process.

Management's Comment

We concur. The Refund and Penalty Waiver (RPW) Unit has a tracking system that is used to monitor the status of each refund received by that unit. The Audit Division will request enhancements to the system for aging refunds over a specific number of days.

Each month, the Unit currently lists in its status report those refunds which have been in the Attorney General's (AG's) office for more than 30 days. The Operations Manager periodically calls the AG's office to inquire about the status of refunds that are more than 30 days old.

Written procedures will be established for supervisors in the Unit to require a closer monitoring of refunds; however, RPW is dependent upon others, at times, in completing the processing of claims for refund.

For claims requiring a signature from the Legal Office, the staff strives to review, approve and transfer the approved claim to the next step in the process within 3 days from the date of receipt unless there are issues to clarify. When issues are raised, the Audit Division is contacted for resolution.

The department has also noted extensive delays when claims are se nt to the Attorney General's Office for approval; however, at that point, processing is out of the department's control except for inquiry about the delay. The department will continue to work with all affected parties to streamline the processing of refund claims.

REVENUE ACCOUNTING

The objectives of our review of the Revenue Accounting section were to determine if

- certain rules, regulations, and laws that affect tax revenues have been identified;
- the cashier's Daily Summary of Collections Report is being properly completed;
- deposit slips are reconcilable to the Bank Deposit Report, the Daily Summary of Collections Report, and the Daily Balancing Report;
- available and measurable revenues have been properly recorded and classified by tax type in the monthly collection reports;

- reconciliations are being performed and are properly documented;
- procedures used to report financial data and prepare collections are proper;
- collections are being reported in the monthly collection report on a consistent basis;
- access to RITS conversation screens is properly authorized and approved, and duties are properly segregated;
- error reports are used to ensure errors are corrected properly;
- procedures used for monthly closeouts are proper; and
- procedures used to reallocate undistributed funds for RITS are proper.

We interviewed key personnel, observed their duties during walkthroughs, and reviewed the RITS manual to determine the functions of revenue accounting and if the duties were segregated. Also, the procedures used for monthly closeout and for reallocation of undistributed funds for RITS were reviewed to determine if they were proper. RITS conversation screens were tested to determine if access was properly segregated. A sample of monthly collections reports was reviewed and tested to determine if they are reconciled to revenue reports issued by the Department of Finance and Administration and if collections are reported on a consistent basis. A sample of out-of-balance reports was tested to determine if appropriate actions were taken to correct the problems. For several tax classes reported in the daily summary of collections reports, we tested the monthly reports to determine if the current-date, month-to-date, and year-to-date totals for each tax type were proper and if the report was reliable. It was noted that out-of-balances are still occurring in RITS (see finding 2 in this report). In addition to the finding, some minor weaknesses came to our attention and have been reported to management in a separate letter.

TAX ENFORCEMENT DIVISION

For the Tax Enforcement Division, our objectives were to determine whether

- rules and regulations of the department and the applicable *Tennessee Code Annotated* sections are complied with;
- regional Tax Enforcement offices are mailing receipts to the department's mail room timely, and the receipts are deposited by the department timely;
- the classification of delinquent RITS accounts as dormant, pending dormant, or unenforceable is properly supported and approved;
- bankruptcy claims are filed timely by the department, and the claims are properly computed and tracked by the department;
- the division is attempting to collect current delinquencies in a timely manner and following the appropriate collection procedures;

- Tax Enforcement officers' receipt books are properly completed and reviewed by their supervisors;
- cash received by Tax Enforcement officers is deposited at a local bank timely;
- Tax Enforcement officers' diaries are properly completed and reviewed by their supervisors; and
- Tax Enforcement officers are properly monitored by their supervisors, regional manager, and the Central Office.

We interviewed key personnel, reviewed tax enforcement's procedures manual and the applicable *Tennessee Code Annotated* sections to determine if the Tax Enforcement Division is in compliance with rules and regulations. A sample was selected for testwork to determine if RITS accounts classified as dormant, pending dormant, or unenforceable are properly supported and approved. A sample of bankruptcy claims was tested to determine if proper action was taken to collect funds, if the funds are deposited properly, if receipt books are handled properly, if diaries are reviewed properly, and if revenue field officers' work is monitored properly. We found discrepancies relating to the controls over certain tax enforcement activities (finding 11). In addition to the finding listed below, other minor weaknesses came to our attention which have been reported to management in a separate letter.

11. Controls in the Tax Enforcement Division need improvement

Finding

The department is not maintaining adequate control over certain activities of the Tax Enforcement Division. Tax Enforcement officers are employed to collect delinquent taxes from taxpayers through phone calls or field visits to the taxpayer's business or home. Although part of the prior audit finding was resolved, two parts were still noted as problems during the current audit. In addition, new problems were noted.

a. As noted in the prior audit, the amounts of bankruptcy claims do not always agree with the amounts of the claims as shown in the Revenue Integrated Tax System (RITS). Seventeen of 60 bankruptcy claims tested (28.33%) did not agree with the amounts owed as shown on RITS. In 13 of these cases, the amounts in RITS were not updated when the claims were manually amended. In two cases, the claims were overstated and the amounts in RITS were correct. In one of these cases, an administrative claim was typed incorrectly, resulting in a claim being overstated by $190,913.75. Also, in two cases, based on the facts of the case, it was determined that it would not be cost-effective to submit an administrative claim; however, RITS did generate the claim. Management concurred with the prior audit finding and assigned an employee to review and file corrected claims as necessary. Since this employee is not ensuring that claim amounts on RITS also agree with the amounts on the amended claims, the problem has not been resolved.

b. Bankruptcy claims are not always filed in a timely manner. Three of 60 bankruptcy claims (5%) were not filed in a timely manner. The first claim in each of these cases was filed 6 weeks to 15 months after the bankruptcy unit received notification of the case. Also, the legal division should be staffed with four attorneys; however, currently there is only one attorney. The lack of adequate staffing delays the follow-up process and greatly reduces the possibility of collection on bankruptcy cases.

c. The Tax Enforcement Division is not following up on cases in a timely manner. Documentation in RITS showed that 28 of 60 tax enforcement cases (46.44%) were not followed up in a timely manner. The case history screen in RITS shows that no action was taken for these cases for 8 to 13 months. In addition, tax enforcement officers are not maintaining adequate documentation of the cases in RITS. In 7 of 60 cases reviewed (11.66%), documentation in RITS did not justify the dormant, pending, or unenforceable status of the case.

d. As noted in the two prior audits, several weaknesses were found during the regional office visits. Although management did address weaknesses in the prior audit dealing with receipt books, they did not adequately address weaknesses dealing with officers' diaries. The tax enforcement officers use diaries to record their daily collection activities. In the prior audit, weaknesses were noted at the Chattanooga regional office. The following weaknesses were noted in the current audit at the Nashville, Columbia, Memphis, and Jackson regional offices. The Chattanooga office was not visited in this audit.

    (1) Based on review of diaries, the regional managers in the middle and west Tennessee regions do not ensure that supervisors are properly performing their review of officer diaries. In addition, regional managers only check to see that supervisors are reviewing diaries quarterly; they do not verify compliance in any other areas of the review process.

    (2) Diaries are not always being reviewed quarterly and are not always being reviewed by the supervisors. Ten of 28 diaries tested (35.7%) were not reviewed quarterly by the supervisor. Tax Enforcement policies and procedures state that officers' diaries must be reviewed at least quarterly by the supervisors. Of the ten diaries where weaknesses were noted; seven were not reviewed on a quarterly basis; three were not reviewed by the supervisor; and one was neither reviewed quarterly nor reviewed by the supervisor. These weaknesses were found in the Nashville, Memphis, and Columbia offices. The Memphis office was the only location where diaries were being reviewed by Revenue Officer 3s instead of the supervisors, as required by the tax enforcement policies and procedures.

    (3) The Tax Enforcement Division's policies and procedures manual requires the reviewing supervisor to indicate the date of review, indicate the period of review, and sign each officer's diary. Thirteen of 28 diaries tested (46.43%) were not

reviewed in accordance with these procedures. Five of the diaries were from the Memphis office, 4 from the Columbia office, and 4 from the Nashville office.

Recommendation

The Bankruptcy Unit should take steps to ensure that claim amounts agree with the amount of the claim in RITS. Also, the department should make certain that the legal division is adequately staffed to handle the volume of bankruptcy cases, to ensure that cases are followed up in a timely manner.

Supervisors and Regional Managers should ensure that revenue officers are including adequate notes in RITS to document all efforts that have been made to collect funds. In addition, supervisors and regional managers should ensure that all cases are followed up in a timely manner and that follow-up dates are properly recorded in RITS.

Either the policies and procedures manual should be amended to allow review of officers' diaries to be performed by Revenue Officer 3s, or the supervisors in the Memphis office should resume the responsibility. Supervisors in all regional offices should review the policies and procedures manual regarding required procedures for diary reviews. Regional managers should review the supervisors' work thoroughly, to ensure that policies and procedures are being properly carried out, specifically in the areas of diary reviews.

Management's Comment

We concur. Due to the nature of bankruptcies and RITS, there are situations where the amounts on RITS will not agree with the total on the bankruptcy claim. For these situations, Tax Enforcement management will emphasize to all personnel, in writing, the necessity of placing notes on the RITS case to explain any differences. Personnel in the division's Bankruptcy Unit will continue to monitor the bankruptcy claims to ensure that they agree with the amounts reflected on the system unless circumstances prevent agreement.

The Bankruptcy Unit within the Legal Office has experienced a complete turnover of staff in recent months. It is now fully staffed with four excellent attorneys. The new Senior Bankruptcy Counsel is doing an outstanding job in reorganizing the Unit and ensuring prior problems and deficiencies are corrected. Great progress has already been made and it is estimated that the Bankruptcy Unit will be operating at full efficiency within the next few months.

The problems noted relating to the timely follow-up of Tax Enforcement cases stem from a review of those assigned to the out-of-state unit which has been understaffed since the implementation of RITS. It has now grown from two Revenue Officers to seven. Management believes that the additional officers will help in the resolution of this problem. In addition, some of these cases will be transferred to Revenue Officers in the in-state unit. The need for adequate documentation in the RITS case notes reflecting all collection efforts including dates will be re-emphasized to all revenue officers.

Tax Enforcement management has discussed with all regional managers the procedure requiring supervisory review of all diaries. All managers will monitor supervisory activities to ensure compliance with the diary review procedures as currently written.

INTERNAL AUDIT

Our objective in reviewing the activities of the internal audit unit was to determine if an adequate review of the RITS system was completed by the internal audit unit. We noted that they had not performed a review of RITS and this was reported to management in a separate letter.

FINANCIAL INTEGRITY ACT

The Financial Integrity Act of 1983 requires each executive agency to annually evaluate its systems of internal accounting and administrative control and report the results of its evaluation to the Commissioner of Finance and Administration and the Comptroller of the Treasury by December 31 of each year.

The objectives of our review of the department's compliance with the Financial Integrity Act were to determine whether

- the agency's reports were filed in compliance with the Financial Integrity Act of 1983,
- documentation to support the agency's evaluation was properly maintained,
- procedures used in compiling information for the reports were adequate, and
- corrective actions have been implemented for weaknesses identified in the reports.

We interviewed key employees responsible for compiling information for the reports to gain an understanding of the procedures. We also reviewed the supporting documentation for these procedures and the reports submitted to the Comptroller of the Treasury and to the Department of Finance and Administration.

We determined that the Financial Integrity Act report was submitted on time and support for the report was adequate.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of Revenue filed its report with the Department of Audit on February 26, 1999. A follow-up of all prior audit findings was conducted as part of the current audit.

The International Registration Plan unit has been moved to the Department of Safety. Therefore, the prior finding regarding the department's controls over the Internal Registration Plan unit will be followed up on as a part of the audit of the Department of Safety.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the Department of Revenue has corrected previous audit findings concerning receipts not being deposited timely, internal controls over IRP, segregation of duties in revenue accounting, review of method to record payments received with franchise and excise tax extension requests, processing of taxpayer payments and accounts, Inheritance and Gift Tax procedures, inadequate refund approvals, and improper handling and safeguarding of returned refund warrants.

REPEATED AUDIT FINDINGS

The prior audit report also contained a finding concerning inadequate security over RITS. This finding has been only partially resolved; a finding concerning the unresolved area appears in this report.

The prior audit report also contained findings concerning problems with the department's Revenue Integrated Tax System; out-of-balance situations; disaster recovery plan; MIS policies and procedures; controls over changes to RITS data; and procedures not being followed relating to changes to taxpayer accounts, refunds, and controls in the Tax Enforcement Division. These findings have not been resolved and are repeated in this report.

OBSERVATIONS AND COMMENTS

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

Tennessee Code Annotated, Section 4-21-901, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by June 30, 1994, and each June 30 thereafter. The Department of Revenue filed its compliance report and implementation plan on June 30, 1997.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds.

On October 15, 1998, the Commissioner of Finance and Administration notified all cabinet officers and agency heads that the Human Rights Commission is the coordinating state agency for the monitoring and enforcement of Title VI.

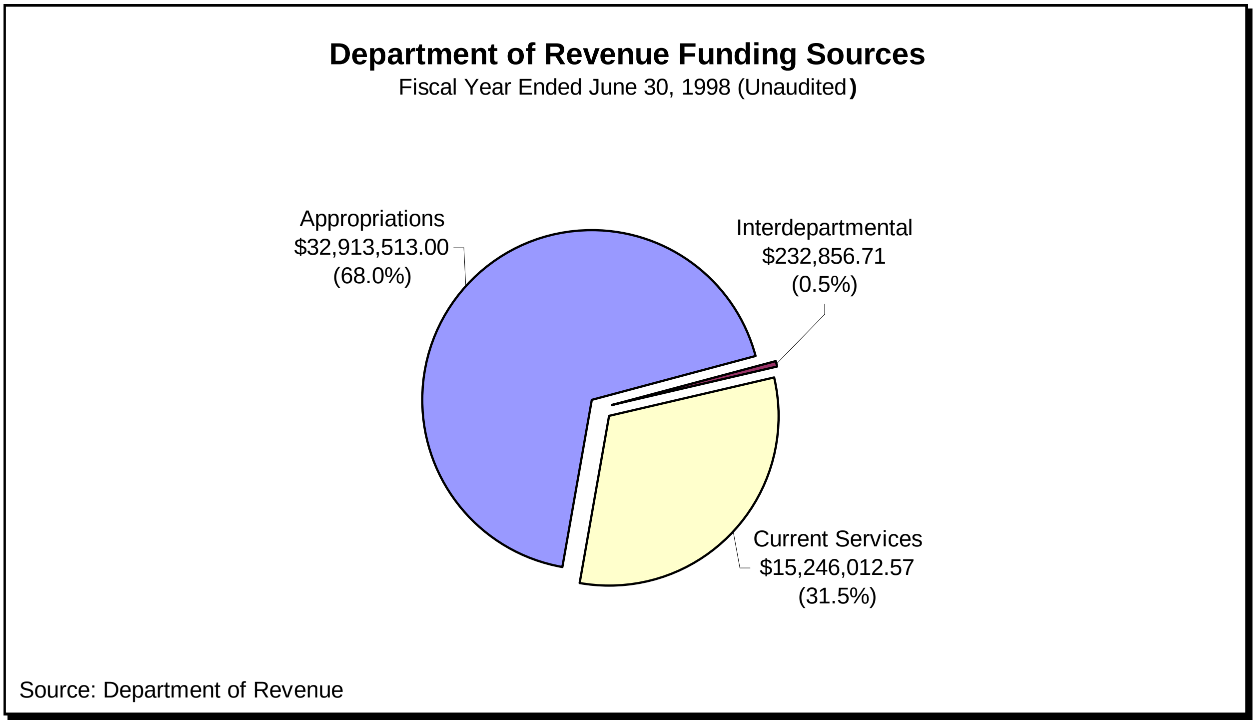
A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report, *Submission of Title VI Implementation Plans,* issued annually by the Comptroller of the Treasury.

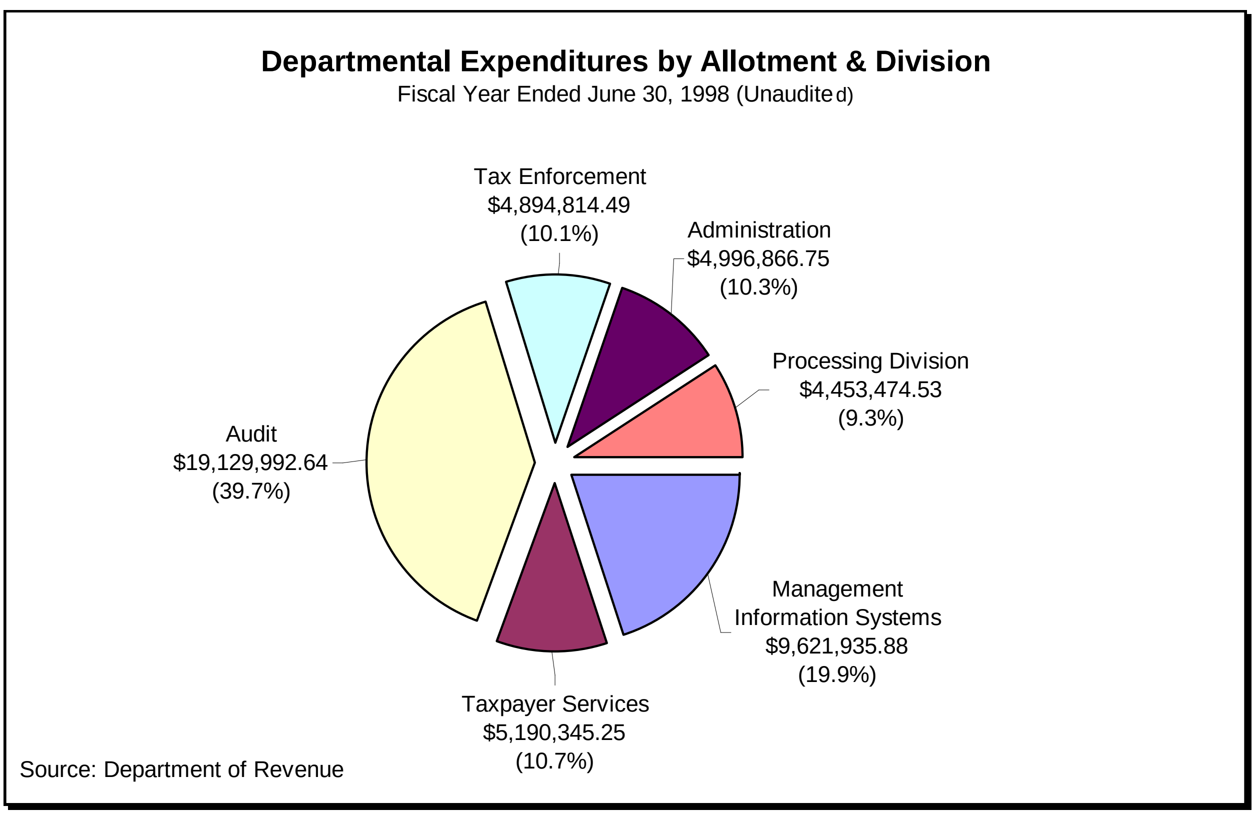
APPENDIX

DIVISIONS AND ALLOTMENT CODES

Department of Revenue divisions and allotment codes:

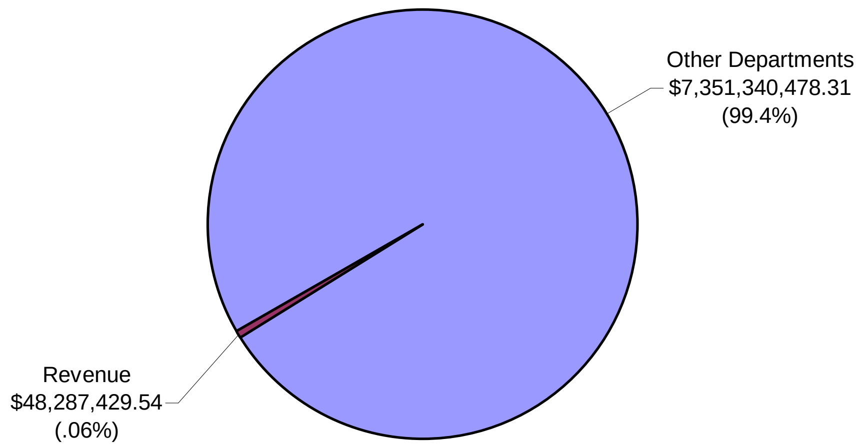
347.01	Administration
347.02	Tax Enforcement
347.11	Management Information Systems
347.13	Taxpayer Services
347.14	Audit Division
347.16	Processing Division


Department of Revenue Funding Sources
Fiscal Year Ended June 30, 1998 (Unaudited)
Appropriations
$32,913,513.00
(68.0%)
Interdepartmental
$232,856.71
(0.5%)
Current Services
$15,246,012.57
(31.5%)
Source: Department of Revenue


Departmental Expenditures by Allotment & Division
Fiscal Year Ended June 30, 1998 (Unaudited)
Tax Enforcement
$4,894,814.49
(10.1%)
Administration
$4,996,866.75
(10.3%)
Processing Division
$4,453,474.53
(9.3%)
Audit
$19,129,992.64
(39.7%)
Management
Information Systems
$9,621,935.88
(19.9%)
Taxpayer Services
$5,190,345.25
(10.7%)
Source: Department of Revenue

General Fund Expenditures

Fiscal Year Ended June 30, 1998 (Unaudited)



Source: Department of Revenue